Chapter 5 Indonesia's Economic Reform: Restructuring of the Banking Sector

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Chapter 5

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Introduction

Abdurrahman Wahid was elected as the Indonesia's fourth president and Megawati Soekarnoputri as vice-president through the democratic process and new cabinet inaugurated on October 26, 1999. The installment of the new government paved the way at last for an economic recovery in Indonesia which is getting a late start among Asian countries jolted by the 1997 currency and economic crisis.

Policies for restoring the Indonesian economy are basically the same as those under the previous government of President Habibie: foreign aid and economic policies based on the conditionality of the International Monetary Fund (IMF). However, the new government has declared itself in favor of policies committed to "transparency," breaking with past policies as seen under the Soeharto ensuing Habibie governments which featured the so-called KKN (collusion, corruption and nepotism), notably the amassing of personal wealth through allegedly illicit means. The new government's policy stance can be perceived in the House of Representatives' decision, taken upon the new cabinet's inauguration, to disclose the long form of an audit report on the Bali Bank scandal and the attorney general's public announcement of his intention to reopen an investigation into Soeharto's allegedly illegal accumulation of wealth. The foreign exchange and stock markets took the launch of the new government by and large in a favorable light but are cautiously watching its policy capabilities.

Kwik Kian Gie, coordinating minister for economy, has stated that the new government's economic policy fundamentally is in line with IMF's prescription. But an announcement of the new economic policy has been postponed because the government wanted to assess the real state of economic conditions after a resumption of IMF loans. This development alone is enough to show how difficult it is to formulate an economic policy in Indonesia at present. Problems gripping the banking sector are no exception. This chapter discusses problems related to restructuring of the banking sector which the AbdurrahmanWahid government should tackle as a priority issue in the course of the country's economic reform.

5. 1 Outbreak of Problems

Amid the Asian currency crisis that started in Thailand in 1997, Indonesia was forced to abandon the U.S. dollar-linked crawling peg system it had adopted back in 1978 and shift to the floating exchange rate system. The rupiah's exchange rate plummeted from 2,300 rupiahs to the dollar to 16,000 rupiahs at the lowest level. The plunge in the currency's value dealt a major blow to the Indonesian economy by bloating the country's external debts which led to the banking crisis.

As of November 1998, Indonesia's outstanding external debts stood at \$138.9 billion, breaking down into \$61.1 billion in public sector debts, \$11.1 billion owed by banks, and \$66.7 billion in obligations of private firms (figures provided by the World Bank). The private companies' debts, at \$66.7 billion, more than trebled from 156 trillion rupiahs in 1996 (\$1.00=2,300 rupiahs before the currency crisis) to 534 trillion rupiahs in 1998 (\$1.00=8,000 rupiahs).

The depreciation of rupiah also affected domestic debts. The drop of the rupiah value resulted in sharply higher prices of imports, pushing up costs of companies that import raw materials and intermediate goods. Companies passed the rises in import prices to prices of their products but were unable to absorb all the cost increases, with their business slipping rapidly into dire straits. Moreover, high interest rates, raised to keep the value of the rupiah, squeezed companies further by requiring larger interest payments. Delayed interest payments from borrowing firms in turn lifted banks' non-performing loan ratios (non-performing loans / total loan assets), leading to a vicious circle of bank management deterioration and credit contraction.

While macroeconomic conditions worsened in the wake of the currency's tumble, companies were faced with difficulties in trade finance. When a currency depreciates, exports grow and imports decline, resulting in an improved balance of trade. In Indonesia, however, exports fell and imports decreased much faster to produce an improved trade balance, the improvement was not favorable to Indonesia. Compared with exporters of primary products standing to directly gain from a weaker currency, manufacturers dependent on imports of intermediate products were severely damaged and their exports went down (see Chapter 6 for details).

After the financial crisis, foreign banks became reluctant to accept letters of credit (L/C) issued by Indonesian banks whose condition was fast deteriorating, and Indonesian banks started refusing to issue L/C for companies that all but lost creditworthiness amid the deterioration in business conditions. These problems helped deteriorate the already-worsening corporate earnings, causing more private sector debts to turn sour.

The banking crisis, meanwhile, originated in the shutdown of 16 banks in November 1997 in line with the IMF's conditionality. The bank closures without the safety net for depositors led to widespread runs on banks, creating a big shock to depositors. Table 5-1-1 shows the rapid worsening of banks' capital adequacy ratios (CAR). The ratios that stayed in positive territory in March 1998 plummeted below zero in only one year, because of the bloating of banks' external debts and sharp rises in bad loans resulting from battered corporate earnings. High deposit rates to attract depositors and low lending rates resulted in negative spreads, harming banks' profitability (see Figure 5-1).

The outbreak of the non-performing loan (NPL) problems and the banking crisis partially stem from the fragility seen inherent in the banking system. That is, bad loans increased for reasons on the part of lenders, as well as for reasons on the side of borrowers. Banks had lent massively to sectors prone to high rates of non-performing loans

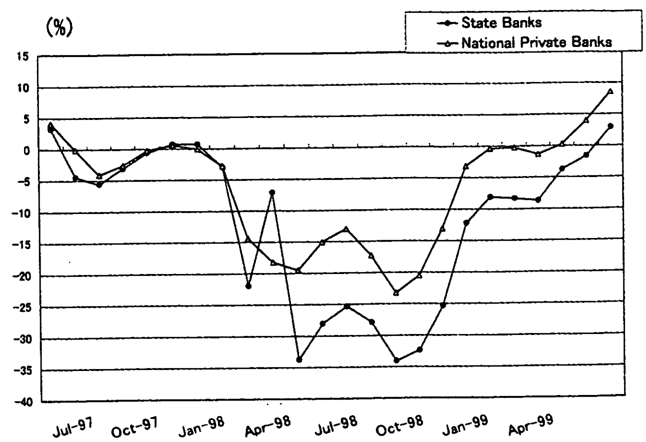
Table 5-1-1 Capital Adequacy Ratio (Net Worth/Total Assets)

(%)

	March 1997	March 1998	Feb. 1999
All commercial banks	12.2	4.3	–24.6
State banks	13.9	2.4	–38.4
Private banks (forex)	10.3	5.3	–18.8
Private banks (non-forex)	9.7	15.9	10.4
Regional development bank	14.7	9.2	13.5
Joint banks	18.0	4.8	–7.7
Foreign banks	13.8	12.8	12.9

Source: Bank Indonesia, *Report for the Financial Year 1998/1999.*

Figure 5-1 Changes in Negative Spreads



Note: Negative spread = Working capital interest – One month time deposit.
Source: Bank Indonesia, *Indonesian Financial Statistics.*

without sufficient credit examinations, or their loans had heavily clustered on specific borrowers. It also appears that the central bank failed to fully perform its role of surveillance over such inappropriate behavior of banks and thus encouraged the increase in non-performing loans and unhealthy management of banks. Indonesian banks were not allowed, by rules, to lend to a specific corporate group or a single borrower more than 20% of their capital. In reality, however, some banks lent out 70 to 90% of their total loans to specific corporate groups. Regulations on banking operations did not fulfill their function.

In the following sections, Indonesia's financial sector is examined from the viewpoint of disposal of private corporate debts and restructuring of the banking sector.

5. 2 Indonesia's Debt Problems

5. 2. 1. Problems of Private Corporate Debts

Debts of private corporations comprise debts in dollar borrowings from foreign financial institutions (external debts of private corporations) and debts in dollar and rupiah borrowings from domestic financial institutions (domestic debts of private corporations).

5. 2. 1. (1) External Debts of Private Corporations

The comparison of $67.0 billion external debts of private corporations with the percentage of domestic finance against the country's economy reveals how large the farmer's impact on the economy is. The end-1998 outstanding loans of all commercial banks amounted to 540.3 trillion rupiahs, equivalent to 57% of the year's gross domestic product (GDP) of 943 trillion rupiahs. The total capitalization of the stock market, another avenue of fund procurement, in 1996 stood at 215 trillion rupiahs[1], or 40% of the 1996 GDP of 532.6 trillion rupiahs. These figures indicate that Indonesia's domestic financial sector is relatively small in size as against the country's real economy. In Thailand, the lending balance and the stock market's total capitalization exceeded the ratio of 100% to its GDP, while the stock market capitalization reached three times the GDP in Malaysia. In Indonesia in 1998, the ratio of external debts of private corporations to the GDP came to 52%. The fact that the external debts became larger than the domestic financial market says it all: foreign capital has been playing a major part in Indonesia's economic development.

5. 2. 1. (2) Domestic Debts of Private Corporations

The ratio of non-performing loans (NPL/total loan assets) was 59% for the entire commercial banking sector of Indonesia and 77% for private commercial banks (foreign exchange banks), far higher than most other countries (see Table 5-1-2). Of the end-1998 lending balance of 540 trillion rupiahs

Table 5-1-2 Non-Performing Loan Ratio (Bad Loan/Total Loan Assets) (%)

	March 1997	March 1998	Feb. 1999
All commercial banks	9.3	19.8	58.7
State banks	14.2	24.2	47.5
Private banks (forex)	4.4	12.8	76.9
Private banks (non-forex)	16.5	19.9	38.9
Regional development banks	13.9	15.8	17.0
Joint banks	7.7	25.3	64.6
Foreign banks	2.7	24.4	49.9

Source: Bank Indonesia, *Report for the Financial Year* 1998/1999.

Table 5-2 Outstanding Bank Loans by Industry

(Bil. of Rp.)

	1993	%	1994	%	1995	%
Agriculture	12,057	8.0	13,860	7.3	15,525	6.6
Mining	777	0.5	799	0.4	913	0.4
Manufacturing	51,432	34.2	60,211	31.9	72,088	30.7
Trade	37,794	25.2	44,372	23.5	54,224	23.1
Services	35,825	23.8	50,806	26.9	66,584	28.4
Others	12,387	8.2	18,832	10.0	25,277	10.8
Total	150,271	100.0	188,880	100.0	234,611	100.0

	1996	%	1997	%	1998	%
Agriculture	17,630	6.0	26,002	6.9	39,308	8.1
Mining	1,693	0.6	5,316	1.4	5,909	1.2
Manufacturing	78,850	26.9	111,679	29.5	171,668	35.2
Trade	70,586	24.1	82,264	21.8	96,364	19.8
Services	91,655	31.3	113,569	30.0	139,124	28.5
Others	32,507	11.1	39,304	10.4	35,053	7.2
Total	292,921	100.0	378,134	100.0	487,426	100.0

Source: Bank Indonesia, *Indonesian Financial Statistics*, Various issues.

for all commercial banks, 319 trillion rupiahs, or 59%, were non-performing loans. But the real picture of the non-performing loans is said to be over 400 trillion rupiahs, and this outstanding figure is widely traced to the inherent fragility of Indonesia's financial sector. Table 5-2 shows the industry-by-industry lending balances of all commercial banks, which reveal the sharp growth of loans to the services sector since 1994. The loans to the services sector include lending to real estate firms, which perceivedly proved to be the major producer of bad loans. But, even if all the loans to the services sector had turned irrecoverable, the sector's share of the total lending market in 1997 was just 30%, a ratio far smaller than the year's overall non-performing loan ratio. So, it would seem more natural to assume that the huge sum of Indonesia's bad loans resulted chiefly from the rapid degrading of loans to the production sector, particularly the manufacturing industry, that accounted for 29.5% in 1997, due to the deterioration in corporate earnings caused by the rupiah's depreciation.

The change in the classification of non-performing loans is also believed to have helped lift the non-performing loan ratio. The Indonesian government made the change in February 1998 as part of the program to restore soundness to the banking sector, a priority area of IMF's conditionality. Under adopting the strict classification standards, the loans which interest payment in arrears one day are treated differently from normal loans and put under the "special mention" category subject to loan-loss provisions (see Table 5-3).

Table 5-3 Classification of Non-Performing Loans

	Classification standards		Provision ratio
Category 1	Normal		1%
Category 2	Special mention	Arrears of one to 90 days	5%
Category 3	Sub-standard	Over 90 dyas	15%
Category 4	Doubtful	Ocer 180 days	50%
Category 5	Loss	Over 270 days	100%

Source: Based on *KOMPAS* and other material.

5. 2. 2 Toward Solving Debt Problems

Movements toward the solution of debt problems began with negotiations on repayments of external debts between parties concerned on their own initiatives, followed by efforts, albeit at a slow pace, to work out domestic debts.

5. 2. 2. (1) Preparation of the Bankruptcy Law and its Limitations

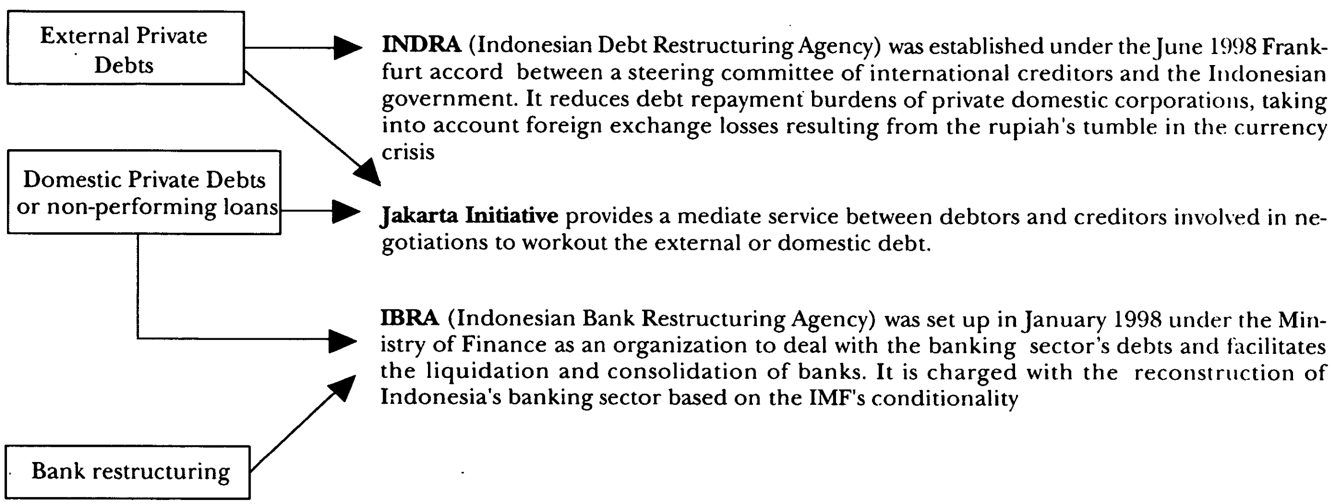
Preparation of the bankruptcy law is of importance to solve problems regarding massive private sector debts. But the law, written back in 1905 under Dutch colonial rule, had long lost its relevance in present-day Indonesia. So, a new bankruptcy law was legislated under the guidance of the IMF. The new law was promulgated on April 22, 1998 and came into effect 120 days later on August 20. The new bankruptcy law provided the legal base for solving corporate debt problems in a prompt and fair manner. A total of 39 bankruptcy cases were filed as of February 1999. Of them, 13 were accepted for bankruptcy adjudication, seven were rejected, six reached composition, five were settled, and eight are still pending. Most bankruptcy adjudication covered small cases involving debts of less than $20,000. As for large-sum cases initiated by foreign creditors, a string of commercial court rejections of creditor claims and the Supreme Court's dismissal of appeals by creditors led to the criticism that the new bankruptcy law is unfavorable to foreign creditors. Courts seem to interpret the new bankruptcy law principally as being designed to facilitate the reconstruction of businesses[2] and tend to pay closer attention to the interests of debtors, with their decisions often hampering foreign creditors' debt collection.

The new bankruptcy law stipulates that a commercial court can declare a debtor bankrupt when (1) the debtor has two or more creditors; and (2) creditors filing bankruptcy claims have at least one debt falling overdue. The problem is that creditors find it difficult to prove to the satisfaction of courts that the debt repayments are overdue. Commercial judges, after several months of training at the newly established commercial courts, handle claims of bankruptcy. But their lack of experience often leads to divergent views and interpretations in the application of the new bankruptcy law. Judges should be given sufficient training to hand down fair decisions under the new law and the law itself should be revised where necessary. Since it may take some more time for the bankruptcy law to start fully functioning as intended in dealing with debt problems, the Indonesian government has set up two institutions to handle debt issues in place: the Indonesian Debt Restructuring Agency (INDRA) for external debts and the Jakarta Initiative for voluntary out-of-court settlements of debt problems (see Figure 5-2).

5. 2. 2. (2) Disposal of External Private Debts and INDRA

INDRA, set up for the resolution of external debts of private corporations, has now only one registered firm, PT Danareksa, a state-owned securities underwriter. Since its June 1998 establishment, INDRA has been besieged with numerous questions about its effectiveness. The reason why INDRA is not functioning effectively lies in the fact that the three parties, government, creditors and debtors, failed to reach a consensus on who should bear the massive foreign exchange losses from the rupiah's sharp depreciation. INDRA is modeled on Mexico's FICORCA (a mechanism for facilitating the rescheduling of external debts of the private sector created in the 1982 Mexican debt crisis), under which the government shouldered the foreign exchange losses and, after a three-year grace pe-

Figure 5-2 Disposal of Private Sector Debts



Source: Compiled by the author

riod, repayments of the external debts were deferred for eight years.[3] In Indonesia, on the other hand, the government cannot bear the foreign exchange losses as they are regarded as subsidies and also because of fears that government guarantees cause moral hazard to debtors in making repayments. In addition, the government hesitates to lay out public funds to workout private corporate debts, partly because ethnic Chinese big businesses are major debtors burdened with external debts. Debtors, reluctant to make repayments, characterize the foreign exchange losses as out of their control.

Under the INDRA scheme, a debtor makes a repayment to INDRA in rupiahs based on the agreed rate of exchange[4] and INDRA then makes the repayment to a creditor in dollars. But the scheme was not utilized at all because of a big difference between the INDRA-set rate of exchange and the rate of 2,300 rupiahs before the crisis. Especially 13,233 rupiahs decided as the first rate of exchange was a far cry from the original exchange rate of external debts. Moreover, while creditors wanted a deferral of only five years, debtors insisted on eight years as under FICORCA. Thus, the INDRA-set rate of exchange was not attractive to debtors. Parties concerned did not come to understand that the fixed interest rate levels of 5.5% plus inflation rate were not necessarily high in terms of effective rates, because the inflation rate was running at nearly 80% a year in 1998. At the same time, creditors found the eight-year deferral of repayments too long. All these factors combined to prevent the INDRA scheme from functioning effectively.

5. 2. 2. (3) Jakarta Initiative

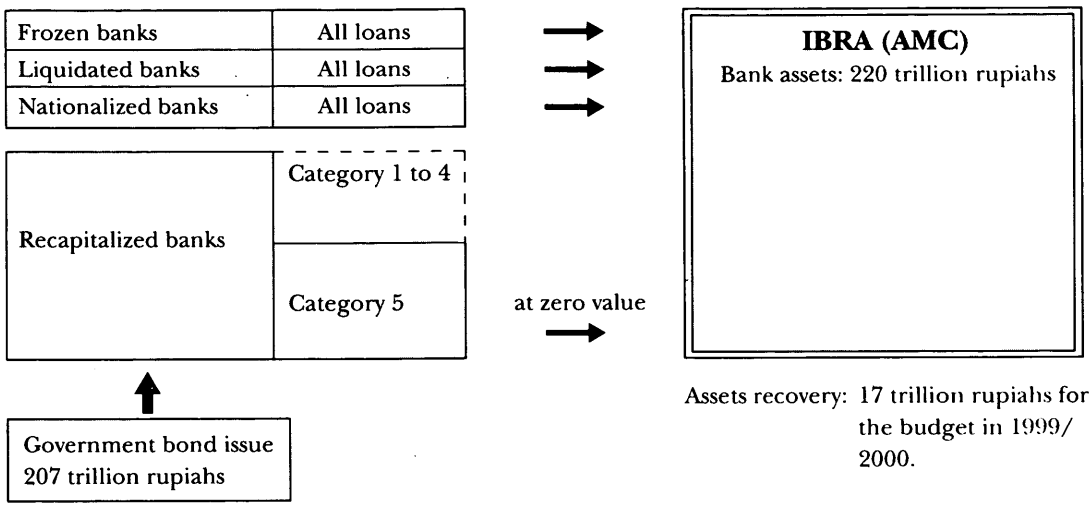
In 1998, 65% of 274 companies listed on the Jakarta Stock Exchange were in the red (as of June 1999), of which 100 companies were on the verge of forced delisting (see Table 5-4). One of the objectives of the Jakarta Initiative was to arrange out-of-court settlements of debt negotiations between compa-

Table 5-4 Loss-Running firms Listed on Jakarta Stock Exchange in 1998

	Total listed firms	Loss carrying	%
Agriculture, Forestry, Fishery	5	1	20.0
Livestock	7	7	100.0
Mining	6	2	33.3
Construction	2	1	50.0
Manufacturing	146	92	63.0
Transportation	7	4	57.1
Telecommunications	2	0	0.0
Distribution	9	5	55.6
Finance, Real estate	79	58	73.4
Hotel, Services	6	4	66.7
Others	5	3	60.0
Total	274	177	64.6

Source: *Indonesia Capital Market Directory 1999.*

Figure 5-3 Transfer of Non-performing Loans to IBRA



Source: Compiled by the author.

nies in financial difficulties and creditors wishing to collect their loans.

A total of 284 companies were registered for the Jakarta Initiative (as of November 1999), with their combined debts totaling $23.3 billion and 15 trillion rupiahs. Of them, 27 companies have reached accords with creditors on their debts. Of domestic private debts, 220 trillion rupiahs – all loan claims of frozen and liquidated banks and irrecoverable loans (Category 5) of recapitalized banks – were transferred to IBRA with zero cost (see Figure 5-3). A portion of other debts were being handled by the Jakarta Initiative, for registered loans of 15 trillion rupiahs. This means that of the domestic private corporate debts, some 60% to 220 trillion rupiahs under IBRA and 15 trillion rupiahs under the Jakarta Initiative – was put on the negotiating table in some form or other. But the remaining 40% of the debts were left to direct negotiations among the parties concerned, and it is likely that the Jakarta Initiative, with no binding authority, is not being effectively utilized as a venue for debt talks.

Here are some specific examples of debt disposal. In June 1999, PT Bakrie and Brothers announced a plan to convert its debt into equities and also issue new shares under the Jakarta Initiative. Also in June, PT Astra International agreed with domestic and foreign creditors on the reschedule of its debts – $1 billion and 1 trillion rupiahs – by converting them into corporate straight bonds and warrant bonds.

Settlements of negotiations came sooner for external debts than for domestic debts, primarily reflecting different fund-raising methods in accordance with the scale of business. Corporations that can raise funds from overseas are limited to blue chips. They are big corporations in business groups, most often owned by ethnic Chinese. On the other hand, most Indonesian local companies borrow funds domestically. The lending to one business group sometimes exceeds $1 billion from two or more foreign creditors, and strong pressure for repayments led to external debt settlements sooner than those of domestic debts. As several debt accords happened to be big-ticket ones, they gave the impression that private corporate debt problems were being solved smoothly. However, in reality, there still is a long way to go before debt problems of small and medium businesses that account for the bulk of private corporate debts are solved.

5. 3 Restructuring of the Banking Sector

5. 3. 1 Disposal of Failed Banks and IBRA

Banks' non-performing loans are being disposed of by transferring liquidated and nationalized banks' all assets and recapitalized banks' irrecoverable loans to the Indonesian Bank Restructuring Agency (IBRA). The bank recapitalization program[5] is all but complete, and IBRA is moving on to its next task.

IBRA has two types of assets under its management. One is "bank assets" of 220 trillion rupiahs by acquiring the above-mentioned banks' loans and assets. Another is "shareholders assets" of 12 billion US dollars that were submitted by bank owners in equity shares as substitutes for recovery of Bank Indonesia Liquidity Support (BLBI) to banks. IBRA plans to report revenues of 17 trillion rupiahs for fiscal 1999 by the sale of assets. The major push for the collection is planned to come from the sale of equity shares of nationalized banks: Bank Bali and Bank Niaga by open tender and of Bank Central Asia (BCA) by initial public offerings. In addition to that, disposal of shareholders assets also contributes to government revenue for budget: sales of equity shares of automaker PT Astra International, and tire maker PT Gajah Tunggal.

IBRA must push ahead with the sale of assets in the next fiscal year to finance the massive cost of bank restructuring in the face of the squeezed state of national finances. Once an economic recovery gets on track IBRA may be able to count on steady interest receipts under its management. Until economic recovery happens, however, keeping the value of assets intact is important.

The evaluation of IBRA's performance so far is not unanimous. Some argue that the sale of assets is making little headway. While others say IBRA did a good job in opening the way for loan collection under tough circumstances, by making public the list of uncooperative debtors and taking a stern attitude by not hesitating to resort to legal action. Both are opinions based on facts. Under Government Regulation No. 17 of 1999, IBRA is authorized to seize the personal assets of an individual shareholder of a debt company to collect a loan extended with the shareholder's guarantee without collateral. With such authority, IBRA was able to go after highly indebted individuals in the Soeharto years who had so far managed to escape prosecution. On the other hand, however, all that IBRA has been able to sell so far is a mere 10% of total assets.

5. 3. 2 Banking Restructuring

In the area of bank restructuring, the acquisition of Bank Bali by Standard Chartered Bank of Britain seemed in the bag in August 1999. But the deal fell through because of the revelation of the Bank Bali scandal[6] and then the process of bank restructuring was suspended ahead of the presidential election. The restructuring of Indonesia's banking sector, where there used to be a total of 240 banks, began with the November 1997 closure of 16 banks, and the central bank provided liquidity support to struggling banks in January 1998 (see Table 5-5) with 100 trillion rupiahs. Also, with the establishment of IBRA in January 1998, the assets of seven banks were transferred to IBRA in April and those of four more in August, while three other banks were liquidated. Then in March 1999, 38 banks were closed down. The number of banks as of March 1999 was reduced to 170, meaning nearly 30% were liquidated or consolidated. The ultimate goal is to cut the number to about 50 banks.

Table 5-6 lists the largest banks in the order of 1997 total assets.[7] Of Indonesia's 240 banks, only 10 to 20 banks were considered sound even before the currency crisis. The table shows that restructuring measures, including privatization, recapitalization and closure, were taken for most banks other than those in the Category A.[8] Banks in Category A are mostly very small banks not subject to restructuring except for several banks like Panin Bank, rather than excellent banks requiring no restructuring steps. The principal targets of restructuring are banks in Category B. As the table indicates, the restructuring program covered major banks at the core of the commercial banking sector. With many banks nationalized, recapitalized or liquidated, Indonesia's financial map has been extensively changed.

5. 3. 3 Costs of Banking Sector Restructuring

The government estimated the cost of solving Indonesia's banking sector problems at 570 trillion rupiahs, or equivalent to 60% of the country's GDP in 1998. The cost to be financed by government bond issues. On May 28, 1999, the government issued bonds for a total of 157.61 trillion rupiahs – 103.83 trillion rupiahs for bank recapitalization and 53.78 trillion rupiahs for the central bank's guarantee program.[9] The bonds of 103.83 trillion rupiahs issued for the recapitalization consist of floating-rate and fixed-rate bonds, as indicated by Table 5-7. The floating-rate bonds allocated to banks with negative capital adequacy ratios (CAR) carry interest rates equivalent to three-month SBI rates and have 16 different maturities from three to 10 years.

Table 5-5 Chronology of Banking Sector Restructuring

November 1, 1997	■	16 banks liquidated
January 26, 1998	■	the deposit protection scheme against bank runs introduced
	■	IBRA established
February 24, 1998	■	54 banks transferred to IBRA's management
April 4, 1998	■	7 small banks suspended from business
	■	Another 7 banks deprived of business rights, shifted to IBRA's management
May 28, 1998	■	Bank Central Asia transferred to IBRA's management
August 21, 1998	■	3 banks liquidated, 4 banks nationalized
September 29, 1998	■	the repayment deadline set for central bank liquidity support
	■	the recapitalization program introduced (funded 80% by the government, 20% by banks)
October 2, 1998	■	4 nationalized banks consolidated into Bank Mandiri
November 13, 1998	■	the recapitalization program set to be completed at the end of 1998
November 19, 1998	■	the plan to liquidate banks with the capital adequacy ratio of less than 4% as of the end of 1998 announced
November 26, 1998	■	the end of the recapitalization program extended to January 1999
December 2, 1998	■	the end of the recapitalization program for listed banks extended to March 1999
December 9, 1998	■	the classification of banks by the capital adequacy ratio announced
January 30, 1999	■	12 banks designated for recapitalization
February 1, 1999	■	the end of the recapitalization program extended to June 1999
February 4, 1999	■	the end of the recapitalization program for nationalized banks extended to June 1999
March 13, 1999	■	9 banks allowed to participate in the recapitalizaiton program
	■	7 banks nationalized
	■	38 banks closed down
April 22, 1999	■	Standard Chartered Bank's plan for capital infusion into Bank Bali unveiled
	■	Bank Niaga nationalized (unable to raise 20% of capital on its own)
May 28, 1999	■	government bonds for 103 trillion rupiahs issued for recapitalizing 23 banks
June 1, 1999	■	200 large debtors to state banks announced by IBRA
	■	more large debtors to state banks announced by IBRA
July 6, 1999	■	12 nationalized banks consolidated into 3 banks
July 26, 1999	■	capital infusion into Bank Bali by Standard Chartered Bank decided
August 4, 1999	■	Bank Bali scandal revealed

Source: Compiled by the author.

Table 5-6 Bank Rankings by Assets ($\boxed{}$ = indicate listed banks)

1997 rank		FY1997 assets (in millions dollars)*	FY1996 assets (in million rupiahs)**	Ownership	Post-consolidation
1	Bank Negara Indonesia (BNI)	12,296	34,882,473	State Bank	
2	Bank Central Asia (BCA)	11,475		Salim	Nationalized in August 1998
3	Bank Rakyat Indonesia (BRI)	8,809		State Bank	
4	Bank Dagang Negara (BDN)	8,743		State Bank	Consolidated into Bank Mandiri
5	Bank Bumi Daya (BBD)	7,322		State Bank	Consolidated into Bank Mandiri
6	Bank Danamon	6,084	22,020,139	Danamon	Nationalized in August 1998
7	Bank Ekspor Impor Indonesia	5,549		State Bank	Consolidated into Bank Mandiri
8	Bank International Indonesia (BII)	5,311	17,707,033	Sinar Mas	Recapitalized
9	Bank Dagang Nasional Indonesia (BDNI)	4,299	16,651,468	Gajah Tunggal	Suspended
10	BAPINDO	3,603		State Bank	Consolidated into Bank Mandiri
11	Bank Tanbungan Negara	3,304		State Bank	
12	Lippo Bank	2,787	10,182,424	Lippo	Recapitalized
13	Bank Bali	2,708	7,999,688	Bank Bali	Nationalized in April 1999
14	Bank Niaga	2,358	7,872,147	Tirta Mas	Nationalized in April 1999
15	Pan Indonesia Bank	1,697	5,374,596	Panin	
16	Bank Duta	1,479	5,278,292	Foundation run by Soeharto	Nationalized in March 1999
17	Bank Umum Nasional (BUN)	1,364	7,147,941	Ongko/Bob Hasan	Suspended
18	Bank Yakin Makmur (YAMA)	1,333		Bukopin	Liquidated in March 1999
19	Bank Universal	1,235	3,465,837	Astra	Recapitalized
20	Bank Indonesia Raya (BIRA)	1,120	2,846,838	Bira	Liquidated in March 1999
21	Bank Bukopin	1,104			Recapitalized
22	Bank Harapan Satosa	811		Harapan	Liquidated in November 1997
23	Bank Buana Indonesia	663		Astra	
24	Tamara Bank	656	2,892,781	Tamara	Nationalized in March 1999
25	Bank Tiara Asia	589	2,169,456	Ometraco	Nationalized in August 1998
26	Bank Private Development Finance Company of Indonesia (Bank PDFCI)	570	2,066,795	Central bank/ Panin/foreign bank	Nationalized in August 1998
27	Modern Bank	511	2,413,313	Modern	Suspended
28	Bank Utama	499			

(cont'd)

1997 rank		FY1997 assets (in millions dollars)*	FY1996 assets (in million rupiahs)**	Ownership	Post-consolidation
29	Sejahtera Bank Umun	492		Tirta Mas	Liquidated in November 1997
30	Bank Umun Servita	457	1,372,684		Liquidated in March 1999
31	Bank Papan Sejahtera	434	1,358,651		Liquidated in March 1999
32	Unibank	420			
33	Bank Aspac	388		Aspac	Liquidated in March 1999
34	Bank Dharmala	379		Dharmala	Liquidated in March 1999
35	Bank Jawa Tengah	374		Regional development bank	
36	Bank NISP	366	1,198,930		
37	Bank Putra Surya Perkasa	365		PSP	Liquidated in March 1999
38	Bank Nusa Nasional	353		Bakrie	Nationalized in March 1999
39	Bank Risjad Salim International	340		Risjadson	Nationalized in March 1999
40	Bank Atra Pratama	330			
41	Bank Mashill Utama	328	1,641,555	Lakop	Liquidated in March 1999
–	Bank Surya		1,476,843	Subentra	Frozen in April 1998
–	First Indonesian Finance and Investment Corporation Bank (Ficornvest Bank)			Central bank/ foreign bank	Liquidated in March 1999
–	Bank Rama		1,246,176		Nationalized in March 1999
–	Inter-Pacific Financial Corporation Bank (Inter-Pacific Bank)		1,020,983	BRI/foreign bank	
–	Indonesian Investment International Bank (Indovest Bank)		915,997	BDN/foreign bank	
–	Bank Century Invest Corporation		554,047		
–	Bank Pikko		322,189		
–	Bank Pos				Nationalized in March 1999
–	Bank Jaya International			Jaya	Nationalized in March 1999

Notes: * *Asian Week*, ***Indonesian Capital Market Directory*.
Source: Compiled by the author based from *Asia Week, Indonesian Capital Market Directory* 1997, and other materials.

Table 5-7 Government Bond Issuance (May 28, 1999)

Object	In billion rupiahs		Interest rate	Interest payment	Maturity	Subject bank	Remarks
Recapitalization	95,149	Floating rate	SBI 3months	Quarterly/4 times a year	3 to 10 years	CAR (Less than 0%)	16 series
103,831	8,682	Fixed rate	12%	Every 6 months/ twice a year	5 years	CAR (0 to 4%)	
			14%	Every 6 months/ twice a year	10 years	CAR (0 to 4%)	
Guarantee program 53,779	53,779	Indexed	3%	Every 6 months/ twice a year	20 years	Central bank Guarantee program	Principal amount adjusted regularly for inflation rate
Total	157,610						

Source: Compiled by the author based on Bank Indonesia materials.

For banks with CAR of zero to 4%, five-year bonds with the fixed rate of 12% and 10-year bonds with the fixed rate of 14% were allocated. The government requires 14 trillion rupiahs a year for interest payments.

While the amount of Indonesia's non-performing loans is equivalent to 43% of its GDP, the cost of restructuring the banking sector is equivalent to a higher 60% of the GDP. This is because many of Indonesian banks have the twin problems of negative CAR and massive non-performing loans. The fiscal spending via the above-mentioned government bonds worth 103.83 trillion rupiahs is intended to raise the CAR to up to 4% for banks with a ratio of less than 4%. All that would be achieved by infusing nearly half of the state budget into the banking sector is the ratio of 4%. It is possible that more capital would become necessary to meet the CAR of 8% required in the latest IMF's Letter of Intent by the end of 2001.

The key to a successful restructuring of the banking sector is healthy management of Bank Mandiri, the nation's largest bank established in August to consolidate the operations of the four state banks. Of Bank Mandiri's assets, about 60%, or 75 trillion rupiahs, is to be transferred to IBRA, but the estimated cost of the bank's reconstruction was revised upward from an original 137.8 trillion rupiahs to 160 trillion rupiahs. This fact alone is enough to suggest that the cost of restructuring Indonesia's banking sector could expand further depending on future developments.

Of the banking sector's non-performing loan assets, 220 trillion rupiahs is set to be transferred to IBRA for public management. Banks have been relieved of certain burdens after being recapitalized and striking irrecoverable credit off their balance sheets, but they still have to set aside provisions for the remaining (see Table 5-3). The question is whether banks can prevent a further degrading of the remaining loans and ensure the resumption of interest and principal payments and whether they can build sufficient provisions for a possible deterioration in the quality of assets. If the Category 4 loans deteriorate into Category 5 assets and have to be transferred to IBRA, the loans under IBRA would rise from 220 trillion rupiahs and could add to the public burden further. The bad loan problems in the private banking sector threatens to keep turning into a public problem until Indonesia's economic recovery gets on track.

Furthermore, the policy of issuing government bonds to finance the restructuring of private sector banks is being called into question. Critics say the measure just shifted the debts of the private sector to the public sector and the government is being forced to shoulder a new burden of interest payments on the bonds issued. Now that the new bankruptcy law is in place, others argue, corporations unable to make good on debt repayments, should be left to go insolvent. The government bonds allocated to banks can be sold on the market one year later. Given the underdeveloped infrastructure of the government bond market, however, whether these bonds can lead to the creation of a benchmark bond market remains a big question mark. If the government bonds fail to win sufficient credit, the government may be forced to raise interest rates to add further to its already-heavy fiscal burden.

5. 4 Problems in the Indonesian Economy

Indonesia's political instability undermined confidence in Indonesia and helped accelerate the depreciation of the rupiah. Indonesia's international credibility was battered further by massive external debts and the high ratio of non-performing loans in the banking sector. The new government's task is to restore confidence in Indonesia and shake off the political and economic instability to encourage investment from overseas.

To ensure a recovery of the Indonesian economy, the banking sector's soundness and revitalization of the real sector are essential. The government set up Bank Expor Indonesia (BEI) on September 1, 1999 to cope with the huge impact of Indonesian companies' difficulty to obtain letters of credit (L/C) on their production activities. BEI's assets of 10 trillion rupiahs came from the government's investment of 3 trillion rupiahs and a loan of $1 billion from the Japan Bank for International Cooperation (JIBC, formerly the Export-Import Bank of Japan). All that BEI did was to provide three credit guarantees in the textile and furniture sector (worth $5 million). In 1998, the Export-Import Bank of Japan extended $1 billion in letter of credit guarantees in bilateral aid, but only about 15% have been used so far. Since BEI has few branches in Riau where export industries are concentrated or Kalimantan and other regions rich in natural resources, it has to extend loans via commissioned local commercial banks. BEI hopes to begin providing medium- and long-term funds to export firms in 2000, and plans to convert itself into an export-import bank.

In the course of the deterioration of the business environment, such as unavailable trade finance, and bank restructuring, the balance of commercial bank credit to private firms shrank. There are no signs yet of a resumption in lending activities. The government has installed a lending program for small businesses to ease the credit contraction. In October 1998, the government provided a total of 10.8 trillion rupiahs in low-interest loans to the agriculture and fishery sectors.[10]

The restoration of soundness to the banking sector, the biggest task in ensuring the country's economic recovery, would require eliminating negative spreads and raising the profitability of individual banks. That must be preceded by the restoration of confidence in banks that should help lower deposit rates. It is also important to revamp bank supervision in order to ensure the soundness of the overall banking system.

As for the central bank's role as bank supervisor, that function is to be transferred to a new Financial Supervisory Agency in 2002 under the new central bank law, enforced in May 1999. The central bank used to have the functions of foreign exchange policy, monetary policy for stable money supply, supervision of financial institutions and credit policy. Under the new law, the central bank's functions are to be limited to the former two; stabilization of the rupiah's value and monetary policy. The credit policy is to be taken over by respective organizations specialized in farm, housing, small and medium business and other specific areas.

Another problem in the Indonesian economy is that the government has accumulated external debts as huge as the private sector's. Indonesia depends on support from foreign countries aid. In fiscal 1998, the Consultative Group for Indonesia (CGI) provided aid of $7.89 billion and plans to provide $5.86 billion in fiscal 1999. Of the bilateral aid of $2.3 billion in fiscal 1998, Japan's assistance of $1.5 billion is by far the largest at 65%. Table 5-8 shows the regional breakdown of Japanese Government's official assistance and investments. The aggregate for Indonesia as of fiscal 1998 amounted to 1.93 trillion yen (equivalent to $14.73 billion), 19.7% of the world total. Indonesia is the biggest recipient of loans and investment from Japan.

Indonesia's external debts, including public assistance and private commercial loans from overseas, are now one and a half times the country's GDP. Payments of principal and interest constantly

Table 5-8 Japan's Public Investments and Loans by Region, Country

(mil. of Yen, composition ratio of %)

Region	Region/country	FY1998 disbursement Amount	%	FY1998 collection Amount	%	FY1998 balance Amount	%
Asia	Bangladesh	8,806	1.0	16,320	5.5	337,208	3.4
	China	139,412	15.4	36,497	12.3	1,381,389	14.1
	India	91,021	10.1	24,128	8.1	912,821	9.3
	Indonesia	270,584	30.0	52,658	17.8	1,928,320	19.7
	Kazakhstan	6,159	0.7	—	—	15,057	0.2
	Republic of Korea	—	—	15,376	5.2	176,085	1.8
	Malaysia	19,847	2.2	8,654	2.9	206,638	2.1
	Myanmar	975	0.1	4,000	1.3	272,510	2.8
	Pakistan	29,360	3.3	2,647	0.9	420,319	4.3
	the Philippines	70,757	7.8	41,144	13.9	862,793	8.8
	Sri Lanka	18,121	2.0	7,847	2.6	229,298	2.3
	Vietnam	29,883	3.3	1,114	0.4	117	1.2
	Others	124,576	13.7	30,744	10.4	990,960	9.0
	Subtotal	809,501	89.6	241,129	81.3	7,733,515	79.0
the Middle East	Subtotal	20,167	2.2	15,727	5.3	518,711	5.3
Africa	Subtotal	28,434	3.1	16,464	5.6	946,777	9.7
Latin America	Subtotal	40,229	4.5	20,920	7.1	528,639	5.4
Oceania	Subtotal	3,205	0.4	1,020	0.3	40,685	0.4
Europe	Subtotal	1,541	0.2	1,156	0.4	25,769	0.3
	Total	903,077	100.0	296,417	100.0	9,794,096	100.0

Source: The OECF (Overseas Economic Cooperation Fund; present JBIC) home page (http://www.jbic.go.jp/) "Business Statistics : Region-by-Region, Country-by-Country Investment and Loans"

account for 21 to 25% of the government's expenditures. The government's external debt servicing nearly matches the intake of aid funds, meaning that the government is using all foreign assistance it gets to make external payments. To help reverse such a situation, the government needs to make a wholesale review of expenditures to put state coffers back on a sound footing, by pursuing policies conductive to increased exports and preventing the misappropriation of funds. As long as the country is run on international assistance, the transparency of administration must be enhanced to meet the international community's stringent evaluation.

Conclusions

The banking sector is one of the areas hardest hit by the currency crisis. Indonesian banks are in deep waters, clobbered by massive non-performing loans and negative CAR. The fragile banking system lies behind all these problems. The banking sector had been expanding since 1983 in the climate of financial liberalization, with insufficient management and monitoring capabilities and little regard to the discipline of accounting and audit. The poor banking system was also responsible for lending regulations that were in name only and was incapable of checking massive intra-group lending or concentrated lending to specific borrowers, while the central bank failed to provide adequate supervision.

The collusion between influential politicians, businessmen and bank managers and the constant easy lending to family-owned businesses without examination and collateral during the Soeharto era turned into the hotbed of non-performing loans, depriving the banking system of efficiency.

Indonesia's banking sector indeed has so many vulnerable spots and, needless to say, these problems must be fixed. However, one should be careful about discussing the direct causal relationship between the aggravation of problems in the banking sector amid the currency crisis-driven deterioration of macroeconomic conditions and the structural vulnerability of the banking sector. As pointed out above, domestic finance does not necessarily occupy such a large part of Indonesia's real economy. So, once the political situation gets stabilized and funds start flowing into Indonesia following Thailand and South Korea with development aid resumption from the IMF and other sources, the real economy might get rolling again and macroeconomic activities might recover without waiting for a recovery of the banking sector. If the economic recovery greases the wheel of interest payments and repayments of loans in arrears, the bad loan problem may well be solved in short order. If that happens, people may misunderstand that the banking sector's weaknesses have been resolved, and behind the economic recovery, miss an opportunity to tackle the structural problems. Even if Indonesia achieved economic recovery without dealing with the banking sector's blind spots, it would be in for the same mistake in the near future. From the long-term point of view, Indonesia needs to tackle structural problems by enhancing banks' examination capabilities, improving financial supervision, and ensuring transparent corporate accounting and governance systems, to build a sound financial system.

(Miki TAKEDA)

Notes:

1 Total market capitalization in 1998 was 175 trillion rupiahs, declining to 18.6% of the GDP.

2 Naoyuki Sakumoto, "Indonesia no shin-hasannho to sono seiteinimiru mondai" (Indonesia's new bankruptcy law and problems in its enactment), *IDE World Trend*, No. 50 (October, 1999).

3 After government guarantees of foreign exchange losses squeezed its fiscal position, Mexico had to reschedule FICORCA again.

4 For the rate of exchange, it was allowed to choose the more favorable one between the floor rate of 13,233 rupiahs to the dollar and the 20-day moving average to the end of June 1999.

5 The recapitalization program, applicable to those banks that submit business restructuring plans and are deemed viable, calls for the government to put up 80% of the necessary capital and banks the remaining 20% on their own.

6 The company called PT EGP was commissioned to collect interbank claims formerly owned by Bank Bali under the recapitalization program on the three closed banks, for an exorbitant fee equivalent to close to 60% of the collected amounts. Since PT EGP's president was a deputy treasurer of the Golkar Party, suspicion emerged that the collection fee was used as political funds.

7 Table 5-6 is based on *Asia Week*'s rankings of the top 500 Asian banks.

8 Category A covers banks with the capital adequacy ratio of 4% and over, Category B from minus 25% to less than 4%, and Category C less than minus 25%.

9 Recapitalization is conducted in the form of the exchange between preferred shares issued by banks and government bonds. In October and December 1999, 178 trillion rupiahs worth of government bonds were issued to raise funds for recapitalizing Bank Mandiri. In 1999, total amount of 501 trillion rupiahs were financed via government bond issues for recapitalizing banks and for BLBI (Bank Indonesia Liquidity Support).

10 This lending program offered low interest rates of 6 to 16% against 40% carried by ordinary commercial bank lending.